

Kevin P. Madden
Deputy Director, OMTR

Southern Company Transmission Forum

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- Introduction
- The Responsibility of Regulators
 - In my view regulators have a clear responsibility to provide regulated businesses with both certainty and flexibility to compete in today's increasingly competitive energy markets. This responsibility is especially critical when the industry is in the midst of restructuring.

- At the same time, regulators also have a continuing responsibility to protect the public interest.

Whether from setting reasonable rates to preventing undue discrimination, we must see that key public goals are met.

- Providing regulatory certainty and flexibility while meeting our public interest mandates often makes for a difficult balancing act. This, in turn, may create uncertainties both for the consumer and the regulated entity.
- We are working hard to reduce this uncertainty for consumers and utilities alike. What's most

important today to electric utility executives is understanding how regulators might balance these tensions in implementing Order No. 2000, and recognizing the policy signals that regulators often send – sometimes subtly, sometimes directly.

Understanding these signal lights on the restructuring road clearly affect how this Commission will treat the regulated entity and thus the ongoing financial viability of a company.

- In my view, a helpful guidepost to look at is the Commission's implementation of Order No. 636 in the natural gas industry. While the gas and electric industries are clearly different, how FERC

implemented Order No. 636 may provide useful insights on how we may implement Order No. 2000.

- The Restructuring of the Gas Industry
 - In 1992, the Commission issued Order No. 636.

There we ordered all open access interstate natural gas pipeline companies to:
 - unbundle their commodity sales services from transportation services, and placed commodity sales on an equal footing regardless of supplier; and

- to initiate a collaborative process for each pipeline to work with its customers and Commission staff to craft an implementation proposal that worked for everyone.
 - Yes, folks it was mandatory!
- Initially, many in the industry did not like the Commission's unbundling mandate. But those who embraced the new competitive landscape early on prospered. And yes there were losers who dragged their feet and did not have the vision to recognize the opportunities that lay ahead. In my view, the losers wanted both the protections of the past and the benefits of the future. They, for example, questioned the effect

of unbundling on reliability and systems operations, and raised the specter of financial ruin if the Commission proceeded.

- Their views were clearly wrong – both tactically and strategically. The earlier-filing pipeline clearly had a regulatory advantage.
- For instance, the Commission provided positive incentives to pipeline companies to embrace competition.
- Additionally, as part of the restructuring process, from both an operational and service standpoint,

the Commission gave early mover pipelines additional flexibility to accomplish the unbundling mandate.

- To be sure, a pipeline's willingness to embrace this competitive opportunity did not affect directly its ability to recover transition costs. Stranded cost recovery was provided at 100 percent.
- And we provided that the pipelines' rate recovery would not be effected by the changes.
- But, if you talk to those executives running pipelines in the early 90s, I think they would confirm that those who

played ball with the Commission were far better off than those who let their litigators and lawyers make business decisions. And I'm pleased to say, over a short period of time, almost all pipelines saw the benefits of competition, not litigation. By the time the Courts heard Order No. 636, most of the pipelines had long since implemented restructuring and embraced competition.

- Following the implementation of Order No. 636, the Commission continued to recognize the pipeline community for its performance by recognizing the need to reform pricing policies to reflect changing market conditions.

- For example, when the pipelines raised legitimate concerns about the deteriorating financial health of the industry, the Commission recognized the increased risks pipelines faced as their customers were given more choice in the marketplace. And what did we do? We made certain adjustments to rate of return to reflect those increased risks.

Today, on average, the authorized return of pipelines are between 13 and 13.5 percent – maybe even a little higher. Of course, I hear from time to time that many pipelines now may be earning more than their authorized rate of rate. But that's another speech for INGAA and pipeline executives!

- We also recognized the market changes and allowed the pipelines to offer a variety of new services through negotiated rates.
- When you sum up the total impact on pipelines, I believe you see a well balanced picture where pipelines were given greater flexibility to compete, coupled with recognition of the changed market risks they faced when setting rates. This occurred at the same time that customers were given greater choices in the commodity market.
- But behind the scene other changes were occurring. What were they? The business side of the companies,

not the lawyers, became the prime movers in explaining and implementing the strategic plans of the company.

- Key Provisions of Order No. 2000
 - So what signals does this send to you all regarding Order No. 2000?
 - In meeting and balancing the mandate I discussed, Order No. 2000 is first and foremost a rule to provide the electric utility industry and consumers with a more workable, more competitive wholesale market for electricity. To the extent the industry succeeds in accomplishing that objective, through the creation of workable regional transmission

organizations, both consumers and competing companies will be better off. I believe this will be true even in those regions or states where retail choice is not on the immediate horizon.

- To accomplish this goal, Order No. 2000 sets forth some important guidelines in RTO establishment.
- The most important of these are the four primary characteristics identified for a well-functioning RTO. These are: independence, proper scope and regional configuration; operational control of the regional grid; and short-term reliability.

- Clearly, the Commission will continue to focus on scope and independence. Just look at the orders we have acted on to date.
- Each RTO also must perform eight functions:
(1) tariff administration and design; (2) congestion management; (3) parallel path flow; (4) ancillary services; (5) OASIS, TTC, and ATC; (6) market monitoring; (7) transmission system planning and expansion; and (8) inter-regional coordination.

- The Commission has also identified the elimination of rate pancaking as a key goal of an RTO.

- I will not belabor you today with a catalogue of Order No. 2000's rules, requirements, and deadlines. I'm sure that you are more than passing familiar with the rule. Rather, I will give you my views on Order No. 2000, and, more importantly, why and how Southern can implement this rule in a timely fashion.

- My advice to you and others in the industry can be stated in simple terms: don't take a back seat or play a waiting game, for if history is any guide,

those that did ultimately lost out in restructuring.

Even if Alabama, Georgia, Mississippi, North

Carolina and South Carolina don't move to

implement retail choice in the near term, Southern,

its customers and shareholders can and will benefit

from timely Order No. 2000 implementation.

- What we've seen in the natural gas industry is quite frankly a sweeping cultural change. Gas industry executives who used to focus all of their attention on regulations, and manipulating the federal regulatory process to maximize shareholder value have become obsolete. Simply put, their day has passed. Gas

companies know this, stockholders know this, and Wall Street knows this.

- To be frank, those gas companies at the top of the natural gas industry today are those who have embraced competition and who took up the challenges associated with restructuring. Their foresight has been rewarded by the market, by Wall Street, and by regulators.
- Relevant to you, as you consider your future in a world organized around the RTO concept, Order No. 2000 includes incentives for RTO participation. These incentives come in several forms. RTOs may enjoy the benefit of:

- A rate moratorium until January 1, 2005.
 - Under this, no one should be worse off or penalized.

- Potentially higher returns on transmission investment.
 - In my view, and my experience with the gas industry shows, higher returns are necessary to spur transmission investment, which is clearly needed. I expect the Commission to consider a number of cases dealing with rate of return in the very near future.

- Non-traditional depreciation rates for new investment.
- Levelized recovery of capital costs.
- Performance-based rates.
 - We should reward efficiencies and penalize inefficiencies. The current cost of service model is outdated and should be overhauled to reflect today's realities.
 - I believe the Commission will follow through on this commitment in the future.
- Acquisition adjustments

- In my opinion, reasonable acquisition adjustments may be warranted, in certain cases to keep a Company whole on a net investment basis. This is especially true if a company, for example, were to spin off its transmission assets to its shareholders or a third party. I will touch more on this issues later.)

- Status of Southern Company's RTO Efforts

- Moving from incentives, I understand that earlier this week, a Southern Company executive discussed the status of Southern's RTO efforts at the SEARUC conference. Let me recount what I've heard, before continuing with my remarks.

- As I heard it, Southern Company is working privately at this time, with some limited participation in the Florida stakeholder process.
- In its private deliberations, I understand Southern is:
 - First, discussing and negotiating with the Georgia integrated transmission system co-owners.

- Second, privately considering business strategy, with a focus on a for-profit transco as the preferred model for an RTO.
- Third, privately studying the options, their costs and potential benefits, including those to consumers with an emphasis on the cost of implementation.
- I understand that Southern Company hopes to complete this work and begin discussing tentative proposals this summer.

- I also understand that Southern has made some preliminary decisions on what form of RTO it will pursue in these discussions.
- It has identified the Southern sub-region of SERC, and intends to focus on the concept of an independent transmission company. In FERC speak, this sounds like a "single company transco."
- Southern is "spending a lot of time thinking about market structure and transmission pricing" especially, "incentives to

appropriately expand the transmission system."

- Let me give you my frank appraisal of Southern's RTO efforts, to date.
- First, I am glad to see that Southern has made some progress since December when the Commission issued Order No. 2000, in considering its core strategic objectives, and options. But compared to some other utilities, there is the strong perception by many at the Commission that Southern Company is taking a "wait and see" attitude.

- Second, I am heartened that Southern has identified some of the key issues it must confront, such as the disposition of the jointly-held Georgia transmission facilities, and the need for incentives for appropriate expansion of the transmission system.
- In this regard, Southern Company has been one of the few utilities which has sought guidance from staff on pricing and return issues. And, I congratulate Southern for this. But, in my view, Southern has not taken full advantage of the advice that staff and the Commission can offer on various issues consideration as it develops its compliance plan. For example, I understand that Southern

Company is concerned about the dilution of shareholder value by divesting of its transmission asset and paying capital gains on the transmission facilities. I believe this is a fair concern. As I said earlier, a reasonable acquisition adjustment for capital gains may be warranted to preserve shareholder value. In my opinion, the Commission should give serious consideration to proposals that gross up the book value of the plant to reflect capital gains paid. I realize that many utilities believe that the language in Order No. 2000 on this is illusory, more rhetoric than reality. However, I think holding shareholders harmless for

capital gains is a powerful argument for allowing acquisition adjustments. Why?

Because of the net benefits gained from separating generation from transmission.

Personally speaking, instead of wringing hands over important issues such as these, Southern Company, and other utilities, should have a heart to heart talk on these issues with the staff, seek their advice, and move on.

- For at end of the day, if the FERC truly wants independent transmission companies, I believe it will have to recognize the effect that existing tax

laws have on business decisions – such as divesting one's ownership of transmission.

- Let me speak candidly: Southern will need to demonstrate its choice for scope and scale whether it's a Southern-only or some other type of Transco proposal.
- First, from the Commission's viewpoint, the critical issues of scope and scale include a region of sufficient size which eliminates artificial impediments to trade. Some have taken the position that RTOs need to follow and support markets of the South, not of the

Southern Company. If their positions are correct, the scope of your RTO will have to accommodate these markets. As you consider your approach, I hope you will be straightforward in addressing the question of whether the scope of a Southern-only Transco is artificially circumscribed and limits market competition.

- Second, by definition, a "sub-region" of SERC, suggests that Southern's RTO may face operational challenges in scheduling services, accounting for loop flows, and in maintaining the level of control and coordination to ensure

short-term reliability. Southern should consider these issues as it goes forward

- Third, while I don't expect the Commission to apply any kind of bright-line test on size, scope, and scale, clearly the Commission will be most comfortable with those proposals which present fewer issues. It is also true that the Commission will have the greatest difficulty with those proposals which present greater operational and market challenges by ignoring the regional nature of electricity trade.

- Finally, let me say a few words about timing. It is now almost July, and more than six months have passed since the Commission issued Order No. 2000. There are just under four months left before Southern Company must file its October 15, 2000 RTO plan with the Commission. Time is short. Southern can make no real progress without discussions with stakeholders, including other utilities and regulators, and without working with the Commission staff to address and resolve issues that may affect its compliance. As you know, the Commission's RTO order is fashioned on a voluntary system; it is not prescriptive; rather it contains a great deal of flexibility, allows for

sufficient time for implementation, and clearly establishes that regional markets have to support and further the goals of open-access and transparency. If the Commission does not receive viable RTO plans from certain subregions or areas of the country, I believe you will have put the Commission in a difficult position and strengthened the hand of those who wanted the Commission to mandate RTO formation.

- Moreover, I believe, competitive forces will not allow this Commission or the Commission as an institution to ignore areas/or subregions of the country that continue to cling to the past and close their eyes to the

competitive opportunities and challenges of the 21st century. And I would remind you that, where mandates have occurred as a result of regulated entities not voluntarily complying with rules, the Commission, traditionally, has been less generous to those laggards than those who have voluntarily complied in the first place.

Conclusion

- Let me close with the words of Bo Whaley, author of that epitome of wisdom, ***Gun Racks & Six-Packs***, who said, "Conclusions are an important part of any speech, especially when they come as close as possible to the beginning." (*at page 389*). I hope I have met Mr.

Whaley's standards today, and I look forward to your questions. Thank you.